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Crowe Transfer Pricing Wednesday

Recent Transfer Pricing Updates from Australia

3 May 2023

Recently the Australian Treasury has proposed to introduce a number of changes that are applicable from 1 July 2023. The proposals are part of the Australian Government's measures to improve tax integrity and tax transparency and other public reporting.

This article seeks to provide an overview of the proposed measures.

Changes to the thin capitalization regime

The proposal changes the Australian thin capitalization regime from an asset-based approach to an earnings-based approach. This is consistent with the OECD's recommended approach to limit deductions to 30% of EBITDA[1]. The proposal introduces the below three tests for general taxpayers:

Fixed Ratio Test (FRT)	• The FRT is the default test and replaces the existing safe harbor test for general class investors. • Under this test, an entity's net debt deductions that exceed 30% of its tax EBITDA would be disallowed. • There is specific guidance on determining the net debt deductions and tax EBITDA. • Any debt deductions disallowed under the FRT in a prior year shall be able to be carried forward for up to 15 years.
Group Ratio Test (GRT)	• A taxpayer may instead choose to rely upon the GRT (replacing the existing worldwide gearing ratio test), which allows an entity to claim debt deductions up to the "group ratio earnings limit" for the income year. • The group earnings limit is worked out by determining the group's net third party interest expense as a ratio of the group's EBITDA. The taxpayer's tax EBITDA is then applied to the ratio and the entity's 'net debt deductions' that exceed this limit are disallowed. • There is no option to carry forward any denied debt deductions under this test.
External Third-Party Debt Test (ETPDT)	• The ETPDT would replace the existing arm's length debt test. • The test operates by disallowing debt deductions to the extent they exceed the entity's "external third-party earnings limit". • This third-party earnings limit is the sum of all debt deductions attributable to third-party debt interest. • The purpose of this test is to effectively deny all debt deductions which are attributable to related party debt, while allowing debt deductions which are used wholly to fund Australian business operations. • Certain concessions are available for conduit financier arrangements, but subject to strict conditions in order to meet these concessions.

[1] Earnings before Interest, Taxes, Depreciation and Amortization

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The proposed law also makes consequential changes to the transfer pricing regulations. Taxpayers are now required to support the arm's length nature of the interest rate of a related party loan as well as the debt amount. As such, if the debt amount or the interest rate is not arm's length in nature, then the reconstruction provisions will trigger, resulting in the application of the thin capitalization tests to the "arm's length" interest expense.

Denial of intangible asset payments

The Australian Treasury issued an exposure draft on denying deductions of payments made for the use of intangible assets to associated entities located in low tax jurisdictions. The object of this proposed legislation is to deter Significant Global Entities (SGE) from avoiding tax by structuring their arrangements relating to the use of intangible assets.

As per the proposed draft, an amount paid for the use of intangible assets to a foreign associated entity will not be deductible for payments made on or after 1 July 2023, if:

- The group constitutes an SGE;
- Payment is made to a foreign associate entity, either directly or indirectly;
- Payment is attributable to the acquisition, use, or exploitation of an intangible asset; and
- The foreign associate entity derives income in a low corporate tax jurisdiction.

The proposal seeks to capture a wide range of payments made for the use of various intangible assets, including issuance of license keys, accessing information on a database, accessing the output of an algorithm. Importantly, deductibility is proposed to be denied even in cases where tax has been withheld on royalty payments or supported by appropriate transfer pricing documentation.

Public disclosure of tax-related information

Under the proposed law, large global groups that operate in Australia, would be required to make public tax-related disclosures for every jurisdiction in which the group operates. These requirements are in addition to the Country-by-Country Reporting (CbCR) requirements that are required to be lodged with the relevant tax authorities.

This would be effective from 2023-24 income years (typically commencing on 1 July 2023) and require in-scope companies to publish the information within 12 months of the year end.

Similar tax transparency and other public reporting measures were introduced in Europe. However, these proposed disclosure requirements go beyond any existing legislated public tax transparency regime elsewhere in the world.

A summary of the proposed law is as below:

<table>
<tr><td>Applicability</td><td>The proposed regulation applies if an entity meets all the below conditions:
It is a CbCR entity;
It is a company incorporated in Australia or a foreign corporation, or a trading or financial corporation incorporated in Australia;
It is an Australian resident; or operates a permanent establishment in Australia; and
It is not exempt.</td></tr>
<tr><td>Details to be provided</td><td>The names of each entity that was a member of the group;
A description of the group's approach to tax;
In respect of each jurisdiction in which the group operates:
Description of main business activities;
Number of employees as at the end of the income year;
Revenue from unrelated parties;
Revenue from overseas related parties;
Expenses arising from transactions with overseas related parties;
Profit or loss before income tax;
A list as at the end of the income year of tangible and intangible</td></tr>
</table>

	assets ◦ The book value at the end of the income year of tangible and intangible assets, other than cash and cash equivalents; ◦ Income tax paid (on cash basis); ◦ Income tax accrued (current year); ◦ Effective tax rate; ◦ The reasons for the difference between the income tax accrued and the amount of income tax due if the effective tax rate were applied to the Profit or loss before income tax; and ◦ The currency used in calculating and presenting the information.
Timeline	• Publication is required to be made within 12 months of year end to the ATO, who will then make it available on the Australian government website
Impact of non-compliance	• Penalties to apply in case of non-compliance

Concluding remarks

The above measures are pursuant to the Australian 2022-23 Federal Budget and consultation on multinational tax integrity and tax transparency. Whilst the proposals are currently in draft and invite comments from the public, the start date for the proposed changes is not far off. It is important that large companies are prepared and proactively manage their tax reporting and compliance obligations.

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